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No. 334

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No.

In the Supreme Court of the United States

October Term, 1967

FRANK IX & SONS VIRGINIA CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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In the Supreme Court of the United States

OCTOBER TERM, 1967

FRANK IX & SONS VIRGINIA CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Benjamin Nadel and Norman Nadel, on behalf of Frank Ix & Sons Virginia Corporation, petitioner, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit.

Opinions Below

The opinion of the Tax Court of the United States entered on March 11, 1966 is reported at 45 T. C. 532. The opinion of the United States Court of Appeals for the Third Circuit entered on April 12, 1967 is reported at 375 F. 2d 867 (Appendix A, *infra* pp. 16-28).

Jurisdiction

The judgment of the United States Court of Appeals for the Third Circuit was entered on April 12, 1967. A petition for rehearing was denied on May 1, 1967. The jurisdiction of the Court is invoked under 28 U. S. Code 1254(1).

The Questions Presented

Whether petitioner which sustained net operating losses during the fiscal years ended March 31, 1953 and March 31, 1954 (years governed by the 1939 Code) while engaged in the manufacture and sale of woven synthetic fibers may carry forward such losses as net operating loss deductions in the fiscal years ended March 31, 1957, March 29, 1958 and March 28, 1959 (years governed by the 1954 Code) to offset income earned in the same business continued at a different location which was acquired for shares of its stock and without change in ownership of its capital stock.

This case raises important issues of law, presently unsettled, by reason of conflicts in decisions in the United States Court of Appeals in several Circuits; whether the deductions claimed are allowable under the 1954 Code unaffected by any provisions in the 1939 Code.

The decision of this Court in *Libson Shops*[1], based on the provisions of the 1939 Code, has been interpreted by the Internal Revenue Service and lower courts with conflicting results particularly in determining the allowance of deductions for loss carryovers in taxable years governed wholly by the 1954 Code.

In *Libson Shops* each of sixteen of seventeen separate corporations, all owned by the same stockholders, operated

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[1] *Libson Shops, Inc.* v. *Koehler*, 353 U. S. 382 (1957).

separate retail stores and the seventeenth provided management services to the others. Three store corporations sustained operating losses during taxable periods ended in 1948 and 1949. On August 1, 1949 all of the sixteen store corporations merged into the management corporation which continued as the surviving corporation. The three stores which sustained losses prior to the merger continued to sustain a net operating loss. In its first taxable year following the merger the surviving corporation claimed a net operating loss deduction for the losses sustained prior to the merger by the three stores. This Court sought to decide whether the surviving corporation was "the taxpayer"[1] having the pre-merger losses of three of those businesses.

The deduction claimed was disallowed because there was a lack of continuity of business enterprise and the "income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses."[2]

The application of this doctrine in the Court of Appeals below has resulted in conflicts with decisions in several circuits.

a) A conflict whether or not the doctrine in *Libson Shops* decided under the 1939 Code applies under the 1954 Code.

b) Whether the decision of this Court in *Reo Motors, Inc.*[3] precludes the application of the doctrine in *Libson Shops* and Section 122 of the 1939 Code when the net operating loss is sustained in years under the 1939 Code and the deduction for the

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[1] *Libson Shops, Inc.* v. *Koehler, supra,* 385.
[2] *Libson Shops, Inc.* v. *Koehler, supra,* 390.
[3] *Reo Motors, Inc.* v. *C. I. R.,* 338 U. S. 442 (1950).

loss carryover is claimed in years governed by the 1954 Code.

c) Whether the doctrine in *Libson Shops* applies under the 1939 Code solely as a limitation on the transfer by merger of net operating loss carryover from one corporation to another.

d) To resolve the conflicting interpretations by the lower courts of the requirement set forth in *Libson Shops,* in order to obtain a loss carryover,—"continuity of business enterprise" by deriving income from "substantially the same business" which produced the loss.

Statutory Provisions Involved

Internal Revenue Code of 1939 (26 U. S. C. 1952 ed.)

Section	23(s)	26 U. S. C.	23(s)
	122(b)(2)(B)	"	122(b)(2)(B)

Internal Revenue Code of 1954 (26 U. S. C. 1958 ed.)

Section	172(a)	26 U. S. C.	172(a)
	172(e)	"	172(e)
	269(a)	"	269(a)
	381(a)	"	381(a)
	381(c)(1)	"	381(c)(1)
	382(a)(1)	"	382(a)(1)
	382(b)(1)	"	382(b)(1)
	382(b)(3)	"	382(b(3)
	393(b)(1)	"	393(b)(1)
	394(a)	"	394(a)
	394(b)	"	394(b)
	394(c)	"	394(c)
	7851(a)(1)(A)	"	7851(a)(1)(A)
	7851(a)(1)(C)	"	7851(a)(1)(C)

Statement of the Case*

The Commissioner of Internal Revenue served on petitioner a Notice of Deficiency (26 U. S. C. 6212). Petitioner filed a petition to The Tax Court of the United States for a redetermination (26 U. S. C. 6213). Upon denial of the appeal a petition for review was filed with the United States Court of Appeals for the Third Circuit (26 U. S. C. 7482). The decision of The Tax Court was affirmed.

In issue were claims for deductions for loss carryover in taxable years ended in 1957, 1958 and 1959.

The petitioner was organized as a New Jersey corporation on or about May 15, 1944 and after several changes in the name was known as Frank Ix & Sons Virginia Corporation. Another corporation, Frank Ix & Sons of Virginia, Inc., a Virginia corporation, was organized on November 18, 1948 and hereinafter this corporation is referred to as the Virginia Corporation. (5a and 6a)

When the Virginia Corporation was organized on November 18, 1948, the persons who owned its stock had also owned, in the same proportions, the stock of the petitioner at its organization. The directors and officers in both corporations were identical at all times pertinent. (6a)

Petitioner and the Virginia Corporation were engaged in the manufacture and sale of woven synthetic fibers. (6a and 7a)

Petitioner maintained and operated a factory at Cornelius, North Carolina (hereinafter referred to as the Cornelius mill). The Virginia Corporation maintained and

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* Page references to Petitioner's Appendix in the United States Court of Appeals for the Third Circuit.

operated a factory at Charlottesville, Virginia (hereinafter referred to as the Charlottesville mill). The same types of looms were used in the Cornelius mill as in the Charlottesville mill. Of the 1,000 looms operated by the Charlottesville mill, more than one third, 352 had been purchased for and operated previously in the petitioner's Cornelius mill. (7a, 8a and 24a)

Other equipment was transferred from the Cornelius mill to the Charlottesville mill all having a value on the books of $163,284 and was used in the Charlottesville mill during the years when profits were earned subsequent to September 30, 1953. (12a)

The same types and styles of cloth were manufactured in the Cornelius mill as in the Charlottesville mill. (6a and 7a)

Frank Ix, Jr. a director and officer in petitioner and in the Virginia Corporation exercised general supervision of the operations in the Cornelius mill and in the Charlottesville mill. (25a)

Petitioner owned a building located in Union City, New Jersey, which at all pertinent times was used by it, the Virginia Corporation and other Ix Companies as a central office for accounting, bookkeeping, inventory control, and yarn purchasing. The same staff of employees performed these services for all the corporations. During the years 1949 to 1959 an office was maintained by Frank Ix & Sons New York Corporation at 1441 Broadway, New York. Such office maintained a completed technical staff, a production and control staff and a sales force, which served all the Ix Corporations, including the petitioner and the Virginia Corporation. Business was solicited throughout the United States. About 70% of the business was from customers in the New York City area. (7a and 8a)

As of September 30, 1953, petitioner, in order to avoid default in a substantial bank loan, acquired the net assets of the Virginia Corporation upon issuance of shares of its stock in a transaction in which neither gain nor loss was recognized. After the reorganization the same persons, with minor exceptions, continued to hold the stock of the petitioner at all times material in the same proportions that they had held its stock and the stock of the Virginia Corporation prior to the reorganization. (8a, 9a, 10a and 11a)

Following the reorganization, the petitioner operated the Cornelius mill and the Charlottesville mill in the same fashion as they had been operated prior to the reorganization. (11a) The manufacturing operations of the Cornelius mill were terminated on or about July 22, 1954 and the same manufacturing operations were continued in the Charlottesville mill. (11a) After termination of operations in the Cornelius mill the equipment was kept in operable condition. (30a and 31a)

The reported amount of petitioner's net operating loss for the taxable year ended March 31, 1952 (after subtracting the portion carried back to prior years) and a portion of its reported net operating loss for the taxable year ended March 31, 1953, were carried over by it and claimed as deductions for its taxable years ended March 31, 1955 and 1956 to the extent of taxable income reported for those years. Respondent did not make any determination of deficiencies for those years. The remaining portion of petitioner's reported net operating loss for the taxable year ended March 31, 1953 and the entire amount of its reported net operating loss for the taxable year ended March 31, 1954, were carried over by it and claimed as deductions from its income of its taxable years ended March 31, 1957, March 29, 1958 and March 28, 1959. The deductions for loss carry overs in these years were disallowed by re-

spondent. (14a) Upon appeal to The Tax Court of the United States[1] the deductions were denied. The United States Court of Appeals for the Third Circuit[2] affirmed the decision of the Tax Court. (Appendix A, infra pp. 16-28)

Reasons for Granting the Writ

The decision of the United States Court of Appeals for the Third Circuit in this case is in conflict with the decisions in

Frederick Steel Co. v. *Commissioner of Internal Revenue,* 375 F. 2nd 351, (1967) Sixth Circuit (Revsg. and Rem'g. 42 T. C. 13);

Maxwell Hardware Co. v. *Commissioner of Internal Revenue,* 343 F. 2nd 713, (1965) Ninth Circuit (Revsg. 41 T. C. 386);

U. S. v. *Jackson Oldsmobile, Inc.,* 371 F. 2nd 808, (1967) Fifth Circuit (Affg. 237 F. Supp. 779).

on the grounds

a) application of the doctrine in *Libson Shops, Inc.* v. *Koehler*[3], under the Internal Revenue Code of 1954

Frederick Steel Co. v. *C. I. R., supra;*
Maxwell Hardware Co. v. *C. I. R., supra;*
U. S. v. *Jackson Oldsmobile, Inc., supra.*

b) construction of Section 172 in the Internal Revenue Code of 1954

Frederick Steel Co. v. *C. I. R., supra;*
Maxwell Hardware Co. v. *C. I. R., supra.*

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[1] 45 T. C. 532 (1966).
[2] 375 F. 2nd 867.
[3] 353 U. S. 382 (1957).

c) construction of the words "continuity of business enterprise"

U. S. v. *Jackson Oldsmobile, Inc., supra.*

The Court of Appeals for the Third Circuit disallowed the loss carryover deductions claimed by petitioner in the taxable years ended in 1957, 1958 and 1959 on the doctrine in *Libson Shops,* lack of "continuity of business enterprise."[1] and relying on Section 122 of the 1939 Code.

In *Frederick Steel Co.* the *Libson Shops* doctrine was rejected as inapplicable to deductions claimed in taxable years beginning after December 31, 1953, governed by the 1954 Code,[2] and that Section 122 of the 1939 Code was not applicable.[3] The taxpayer in this case sustained losses in the beer and ice business and in holding real estate prior to 1954. In that year it acquired and continued to carry on thereafter an entirely different business. Deductions were claimed in the years 1955, 1956, and 1957 for the carryover of these losses to offset the earnings in the new and different business. There was no change in the ownership of its capital stock from the time the losses were sustained and through the years in which the deductions were claimed. The deductions were allowed consistent with *Reo Motors, Inc.*[4] and pursuant to Section 172(a) of the 1954 Code. The court rejected the contention that the *Libson Shops* doctrine barred the deduction claimed

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[1] *Allied Central Stores Inc.* v. *C. I. R.*, 339 F. 2nd 503, (CA-2, 1965) cert. den., 381 U. S. 903, followed. By letter dated March 17, 1967 respondent submitted to the United States Court of Appeals for the Third Circuit that *Frederick Steel Co., supra,* was in direct conflict with *Allied Central Stores, Inc., supra.*

[2] 28 U. S. C. 7851(a)(1)(A).

[3] 375 F. 2nd 351, 354.

[4] 338 U. S. 442, 450 (1950), discussed on p. 12 herein.

under the 1954 Code.[1] The court stated that Congress, in its effort to remedy the situation existing under the 1939 Code, dealt with in *Libson Shops,* sought in 1954, a new fully integrated revenue code. This consisted of Sections 172, 269, 381, and 382. Both House and Senate Committees reported at that time that present practice rests on court-made law which is uncertain and frequently contradictory. Moreover the allowance of the carryover should be based on economic realities rather than upon such artificialities as the legal form of reorganization. Section 172 provides that a net operating loss shall be a net operating loss carryover without mention of the *taxpayer's* having sustained such a loss.[2] The Third Circuit in petitioner's case, in conflict with the Sixth Circuit, held that the deduction claimed by petitioner pursuant to Section 172 was not available to it, even though this section governed taxable years beginning after December 31, 1953, because the plan of reorganization in which it was a party was adopted prior to June 22, 1954.

In *Maxwell Hardware Co.*[3] the taxpayer claimed in the taxable years ended in 1957 to 1960 inclusive loss carryovers sustained in the taxable years 1951 to 1955. A new and different business was undertaken in 1954, and the loss carryover was applied to the earnings in subsequent years from the new business. There was not such a change in ownership of its capital stock from the time the losses were sustained and through the years in which the deductions were claimed which would attract the limitation on the loss carryover deduction pursuant to Section 382(a) of the 1954

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[1] This contention by the respondent is set forth at length in T. I. R. No. 773, October 13, 1965, also that it will not follow *Maxwell Hardware Co.* In *Frederick Steel Co.* the Sixth Circuit cited *Maxwell Hardware Co.* with approval, *supra,* 354.

[2] *Frederick Steel Co., supra,* 354.

[3] Followed in *Frederick Steel Co.*

Code. The doctrine in *Libson Shops* was rejected as inapplicable to years governed by the 1954 Code and the deductions claimed for the loss carryovers were allowed pursuant to Section 172 of the 1954 Code. Further, the court held that *Libson Shops* had no precedential value with respect to the 1954 Code by reason of the legislative history of 1954 Code.[1]

In *Jackson Oldsmobile, Inc.* the taxpayer claimed in taxable years 1956 and 1957 deductions for loss carryovers for losses sustained in 1953 and 1954. Changes in ownership of a minority interest in the stock of the taxpayer occurred in the interval between the loss years and later profitable years in which the deduction was claimed, but did not attract the limitation imposed by Section 382(a) of the 1954 Code. The doctrine in *Libson Shops* was rejected as inapposite and the deductions claimed for the loss carryovers were allowed.[2]

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[1] *Maxwell Hardware Co., supra,* 716, 718 and 722. U. S. Cong. & Adm. News, 1954, Vol. 3, House Report, pp. 4066 and 4192, Senate Report, pp. 4683 and 4847.

[2] This case was decided in the Fifth Circuit solely on the 1954 Code. The taxpayer, in the interval between the loss years and the subsequent profitable years radically changed ownership, corporate structure, location of business and the product. Nevertheless the loss carryover deductions were allowed. The District Court (237 F. Supp. 779, 782) held that the 1954 Code applied and provided an objective standard to determine the availability of carryovers "to the exclusion of the rationale of *Libson Shops, Inc.* v. *Koehler*". In an earlier case in the Fifth Circuit, *Foremost Dairies, Inc.* v. *Tomlinson,* 341 F. 2nd 580 (1965) the taxpayer underwent radical changes in ownership, corporate structure, changed the location, management and type of business as well as products. The deductions for a loss carryover were claimed in 1949 and 1950 for losses suffered in prior years. This case was decided under the 1939 Code and the doctrine in *Libson Shops* was applied to disallow the deduction claimed.

In *Jackson Oldsmobile, Inc.*, although there was a change in location of the business, the introduction of new and different management and a change in product after the losses had been sustained, the income against which the offset was claimed, earned in taxable years after these changes, was determined to have been earned in substantially the same business in which the losses were sustained; there was continuity of business enterprise. In petitioner's case there was only a change in location of the business after the losses were sustained, the management and product remained the same, yet the Court of Appeals for the Third Circuit reached a contrary decision in conflict with the Fifth Circuit.[1]

In *Reo Motors, Inc.*[2] this Court held that the net operating loss must be computed solely on the basis of the law in effect during the taxable year in which the loss was incurred. The net operating loss deduction which may be taken in any one year depends on the law in effect during that year.

In *Jackson Oldsmobiles, Inc.* the District Court, in accord with this Court in *Reo Motors, Inc.*, held that the 1954 Code governed the claim for the deduction of the loss carryover because "the relevant events (other than the losses) occurred in 1955 and 1956".[3]

Nevertheless, inconsistent with *Reo Motors, Inc.*, the Third Circuit, applying the provisions of the 1939 Code, disallowed the deduction for the loss carryover claimed by petitioner in taxable years ended in 1957, 1958 and 1959 under Section 172 of the 1954 Code.

Had *Libson Shops* involved years governed by the 1954 Code the same decision could not have been made because

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[1] See also *Frederick Steel Co., supra*; 354.

[2] *Reo Motors, Inc.* v. *C. I. R.*, 338 U. S. 442, 450 (1950).

[3] 237 F. Supp. 779, 782, Aff'd., 371 F. 2nd 808, (CA-5, 1967).

Section 381 expressly allows the transfer of the loss carryover to a successor, the limitations of Section 382 would not apply and Section 172(a) allows the loss carryover deduction applicable to taxpayers generally.[1]

In *Allied Central Stores*[2] the Second Circuit, following *Julius Garfinckel & Co.*[3] (decided wholly under the 1939 Code), ruled that the *Libson Shops* doctrine is applicable when a loss corporation acquires by merger a new business as well as when a profitable business acquires by merger a corporation with available net operating loss carryovers. Footnote 9 in *Libson Shops*[4] appears to exclude from the purview of the case the single taxpayer cases involving corporations which claim their own pre-merger loss experience.[5] In petitioner's case the Third Circuit denied to it the benefit of its own losses and thereby extended the *Libson Shops* doctrine into an area apparently not contemplated by this Court. In *Libson Shops* this Court held that the carryover privilege is not available unless there is a continuity of business enterprise. The criterion for "continuity of business enterprise" is whether the current year's income, against which the offset is to be applied, was derived from "substantially the same business" which produced the loss. The interpretations of "substantially the same business" have been expressed by the

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[1] See *Libson Shops, Inc., supra,* 385 (footnote 2) and *Maxwell Hardware Co., supra,* 716 and 718.

[2] 339 F. 2nd 503, (CA-2, 1964).

[3] 335 F. 2nd 744, (CA-2, 1964).

[4] *Supra,* 390.

[5] ". . . the surviving corporation in a merger is generally entitled only to the tax attributes from its own pre-merger experience . . ."

U. S. Cong. & Adm. News, 1954 Vol. 3, House Report on the 1954 Code, page 4066.

See *Jackson Oldsmobile, Inc.* v. *U. S.,* 237 F. Supp. 779, Affd., 371 F. 2nd 808, (CA-5, 1967).

Courts of Appeal in many of the Circuits in such varying terms that a welter of confusion exists.[1]

Importance of Question

The resolution of the conflict in the decisions in petitioner's case in the Third Circuit, and *Allied Central Stores, Inc.* in the Second Circuit, with decisions in Fifth, Sixth and Ninth Circuits affects the collection of the federal revenue and the uniform application of the relevant federal tax laws. The conflict centers on the construction of Section 172 of the 1954 Code with respect to deduction of loss carryovers claimed in taxable years beginning after December 31, 1953, a matter of continuing importance, and Sections 394, 395 and 7851 of the 1954 Code relating to the effective dates of Sections 172, 381 and 382 of the 1954 Code, affecting many taxpayers.

The extension into the years governed by the 1954 Code of the doctrine in *Libson Shops* and new dimensions given to Section 122 of the 1939 Code have created confusion for taxpayers, the Internal Revenue Service and courts. The confusion is aggravated by reason of the enactment of the 1954 Code prior to the decision in *Libson Shops*.

The meaning of "continuity of business enterprise" in *Libson Shops* may or may not be the same as "continue to

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[1] *Federal Cement & Tile Co.*, 338 F. 2nd 691, (CA-7, 1964) Aff'g 40 T. C. 1028.

Farwick Corporation, 342 F. 2nd 823, (CA-6, 1965) Aff'g 23 T. C. M. 194.

Foremost Dairies, Inc. v. *C. I. R.*, 238 F. Supp. 258, 262, Aff'd. 341 F. 2nd 580 (CA-5, 1965).

Jackson Oldsmobile, Inc. v. *U. S.*, 237 F. Supp. 779, 786, Aff'd. 371 F. 2nd 808 (CA-5, 1967).

carry on a trade or business substantially the same . . . " in Section 382 (a)(1)(c) of the 1954 Code.[1]

The doctrine in *Libson Shops* may not be applicable in the single corporation cases, such as petitioner's, when additional assets are acquired for stock without change in ownership of stock or character of business.[2]

The issues which have flowed from the interpretation of *Libson Shops* have generated extensive litigation and confusion for taxpayers, the Internal Revenue Service, and courts (cited in more than 70 reported cases) in many conflicting rulings and decisions, and should be settled by this Court.

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[1] *Maxwell Hardware Co., supra,* 722-723.

[2] *Norden Ketay Corp.* v. *C. I. R.,* 319 F. 2nd 902, 906 (CA-2, 1963).

Conclusion

To protect the integrity of the decision of this Court in *Reo Motors, Inc.,* to resolve the conflict existing in the decisions in the United States Court of Appeals in several of the circuits affecting many important and frequently used sections of the Internal Revenue Code presently in effect, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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New York, New York
July 7, 1967

APPENDIX A

Here are set forth the opinion and the judgment of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 16131

FRANK IX & SONS VIRGINIA CORPORATION
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Argued January 6, 1967

BEFORE MCLAUGHLIN, SMITH and FREEDMAN, *Circuit Judges*

OPINION OF THE COURT

(Filed April 12, 1967)

FREEDMAN, *Circuit Judge:*

Petitioner attacks the Tax Court's disallowance of net operating loss carryover deductions on losses which it incurred prior to a reorganization.

The Ix family, through a number of corporations, was engaged in the manufacture and sale of woven synthetic fibers. Separate corporations operated separate mills which manufactured the same types and styles of cloth within the multi-corporation structure. A central office was maintained for accounting, bookkeeping, inventory control and yarn purchasing. There was also provided a central sales force as well as complete technical and production and control staffs. Orders were solicited and returned to a central office in New York where the production and control department determined on the basis of work load and availability of skilled operators which corporation would manufacture the cloth.

In 1952 Frank Ix & Sons, Inc., borrowed $3,000,000 from a bank to make loans to a number of Ix family corporations. To secure the bank indebtedness it pledged as collateral all the capital stock which it owned in the other Ix family corporations and the promissory notes which it received from them for their participation in the loan. One of the conditions of the bank's loan was the maintenance in specified amounts of the working capital of the family corporations.

One of the Ix family corporations operated a mill in Cornelius, North Carolina. Because of the similarity in names of the various Ix corporations and the change in the corporate name of the petitioner, we shall refer to this entity as "Cornelius Ix." Cornelius Ix received $2,550,000 from Frank Ix & Sons, Inc., the major share of the bank loan. In accordance with the bank's requirement, Cornelius Ix agreed that it would maintain its working capital in the amount of $2,800,000. More than a year and a half later, when Cornelius Ix's working capital had fallen nearly a million dollars below the stipulated requirement, a plan of reorganization was adopted with the bank's approval by which there were transferred to Cornelius Ix all of the

assets of another Ix family corporation which operated a mill in Charlottesville, Virginia, and which we shall for convenience refer to as "Charlottesville Ix." Both corporations were engaged in the manufacture and sale of woven synthetic fibers, and their common stock was owned in the same proportions by Ix family members. Pursuant to the plan of reorganization Charlottesville Ix transferred all its assets to Cornelius Ix, in return for which Charlottesville Ix received new common stock of Cornelius Ix on the basis of thirteen shares of Cornelius Ix for each outstanding share of Charlottesville Ix. Charlottesville Ix then distributed these shares to its stockholders in complete liquidation and was dissolved. The plan of reorganization was fully consummated on September 30, 1953, and Cornelius Ix changed its name to Frank Ix & Sons Virginia Corporation, the petitioner. It is conceded that the transaction constituted a valid, tax-free "D reorganization" under § 112(g)(1)(D) of the Internal Revenue Code of 1939. After the reorganization the same persons held the common stock in the new corporation in the same proportions as their pre-reorganization holdings in Cornelius Ix and Charlottesville Ix.

Cornelius Ix had operated its mill at a loss before the reorganization for the years ending March 31, 1952 and March 31, 1953. After the reorganization, petitioner operated both the mill in Cornelius, North Carolina and the mill in Charlottesville, Virginia, maintaining separate records for each of them, until July 22, 1954, when it shut down the North Carolina mill, which had continued to operate at a loss. The Charlottesville, Virginia mill had realized taxable net income in the years prior to the reorganization and continued to operate at a profit thereafter. For the year ending March 31, 1954, the first fiscal year after the reorganization, petitioner showed a net loss from the operation of the Cornelius mill for the period from

September 30, 1953 to the end of the fiscal year, and sustained a net operating loss for the full fiscal year.

What is before us now is the determination by the Commissioner of deficiencies resulting from petitioner's deduction on its 1957, 1958 and 1959 income tax returns of net operating losses sustained by Cornelius Ix for the fiscal year ending March 31, 1953,[1] and by Cornelius Ix and petitioner for the fiscal year ending March 31, 1954. The action of the Commissioner was upheld by the Tax Court on the ground that the deductibility of the net operating loss carryovers was determined by the 1939 Code, under which the deduction was barred by the doctrine of *Libson Shops, Inc.* v. *Koehler,* 353 U. S. 382 (1957). *Frank Ix & Sons Virginia Corporation (N. J.)* v. *C. I. R.,* 45 T. C. 533 (1966).

In the Tax Court petitioner's argument for the deductions rested on two grounds. One was that the *Libson Shops* doctrine was inapplicable to the transaction because Cornelius Ix, which acquired the assets of Charlottesville Ix, was a loss corporation, which made the situation radically different from that with which the *Libson Shops* doctrine dealt. The second contention was that in any event the "continuity of business enterprise" requirement of the *Libson Shops* doctrine had been met.

These two contentions lead us back to the *Libson Shops* case, which the Supreme Court decided in 1957 under the 1939 Code. There a number of individuals directly or indirectly owned in the same proportions the stock of seventeen corporations. One of the corporations provided

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[1]The net operating loss for the fiscal year ending March 31, 1953 was carried over only in part to the years here involved. Petitioner utilized a portion of it in earlier returns which the Commissioner did not challenge.

management services for the remaining sixteen corporations, each one of which, separately operated, was engaged in the retail sale of women's apparel. Each corporation filed a separate income tax return. In a tax-free reorganization the sixteen operating corporations, three of which had been sustaining losses and thirteen of which had been profitable, were merged into the management corporation. The Commissioner disallowed the deduction by the surviving corporation from its net income derived from the thirteen profitable units of the losses carried over from former years of the three unprofitable corporations. The Supreme Court found it unnecessary to decide the Commissioner's primary contention that the surviving corporation was not the same "taxpayer" as that which had sustained the losses in the prior years.[1] Instead the Court disallowed the deduction on the ground that the losses, and the profits from which they were sought to be deducted, were not produced by "substantially the same businesses." The Court thus chose to decide the case on the basis of economic substance rather than on the more technical question whether the surviving corporation was the same "taxpayer" as the constituent units which had sustained the losses.

The *Libson Shops* case has given rise to a flood of discussion and much dispute regarding its application in particular circumstances.[2] The facts in the present case

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[1] Sections 23(s) ad 122(b)(2)(C) of the 1939 Code authorized a net operating loss carryover for three years "if for any taxable year beginning after December 31, 1947, and before January 1, 1950, *the taxpayer* has a net operating loss. . . ." (Emphasis added.)

[2] See, e.g., Comment, Loss Carryover—The Viability of the Libson Shops Doctrine under the 1954 Code, 61 Northwest. L. Rev. 555 (1966); Tarleau & Hodes, Libson Shops and the 1954 Code, 20 Southwest. L. J. 258 (1966); Harris, Libson Shops and Related Cases, N. Y. U. 21st Inst. on Fed. Tax 1307 (1963); Comment, Loss Carryovers and the Libson Shops Doctrine, 32 U. Chicago L. Rev. 508 (1965).

however, fall so remarkably close to the circumstances which existed in *Libson Shops* and we therefore stand so close to the center of the doctrine that there is no need to consider its application in the more remote areas in which its repercussions may be felt. The decisive fact in *Libson Shops* was that a number of individuals had chosen to cast their investment into seventeen separate corporations and thus to spread the risk of their undertaking among separate business units and to enjoy the benefits of separate incorporation and separate tax returns for each of them. Thus, by their own choice they made each corporation a separate business unit as well as a separate taxpayer. The Court therefore determined that they could not disregard this choice in order to enjoy the deduction of a net operating loss carryover of one taxpayer-business unit from the profits of another, separate taxpayer-business unit by a formal act of corporate merger. The court believed that such a deduction was forbidden by the policy underlying the allowance of net operating loss carryovers, which was to protect a single business from the hazards of fluctuating income. The establishment of the seventeen separate business units was a choice in the opposite direction; within each individual unit the loss carryover provision applied, but the investors could not enjoy that benefit and also reap the contradictory advantage, by merger, of enjoying the loss carryover advantage beyond the boundaries of the individual unit.

In the present case, as in *Libson Shops,* individuals chose to cast their investment into separate corporate units, each of which was a separate economic entity as well as a separate legal entity, and the assets which produced the income against which earlier losses were sought to be applied were different from the assets which produced the losses. If the separate businesses had not been combined there would have been no right to utilize the net operating

loss carryover from the unprofitable corporation to reduce the taxable income of the profitable corporation. Whatever differences exist between the factual circumstances in the present case and in *Libson Shops* are not of decisive significance. The fact that what occurred here was not an "A reorganization", a statutory merger, but instead a "D reorganization", a transfer of assets for stock, is a factual difference without any legal distinction. The policy of *Libson Shops,* where indeed there was a retention of one hundred per cent control, cannot be diminished because the "D reorganization" involved here was subject to a statutory requirement of eighty per cent retention of control of the transferee corporation by the owners of the transferor corporation.

Petitioner earnestly contends that the fact that here the loss corporation acquired in reorganization the assets of the profitable corporation significantly distinguishes this case from *Libson Shops,* where the central service corporation absorbed by merger the remaining sixteen corporations including the three loss corporations.

Shortly after the Supreme Court decided *Libson Shops* the view was advanced that the decision might have been different had the loss corporations survived. For there would then not be present the implication that the transaction was without a business purpose, which is so clearly evident when a loss corporation is acquired by a profitable corporation, a transaction which ordinarily has no economic advantage except for the net operating loss carryover which the absorbing corporation, as a result of taking over the shell, can apply against its net taxable income. On the other hand, if the loss corporation is the survivor in the reorganization, it is to be looked upon as the business enterprise which continues, and this prevents regarding it as an empty shell acquired by another merely for the pur-

pose of enjoying its accumulated net losses. In addition, where the loss corporation is the survivor, the identity of the corporation which had sustained the original losses and the corporation which is carrying them forward to the tax year for deduction is the same, and this satisfies the requirement, which *Libson Shops* had emphasized, that the deduction must be taken by the same taxpayer which had suffered the original loss.[1]

These distinctions, however, are too artificial for application in dealing with economic realities. It is easy enough for those planning a reorganization to turn the shell on end and make it the surviving corporation if this difference will have substantial tax advantages. The courts to which the question has been presented therefore have rejected the distinction. *Allied Central Stores, Inc.* v. *C. I. R.*, 339 F. 2d 503 (2 Cir. 1964), cert. denied, 381 U. S. 903 (1965); see *Julius Garfinckel & Co., Inc.* v. *C. I. R.*, 335 F. 2d 744 (2 Cir. 1964), cert. denied, 379 U. S. 962 (1965).[2] We agree with this view, especially where, as in this case, the corporations involved were originally owned by the same individuals, whose proportionate interest in each corporation was the same. The conclusion is compelled by the underlying policy of *Libson Shops* that losses incurred by a business unit should not be applied against profits which come from other assets which the shareholders had originally decided to operate separately, even though each unit is owned by the same group of shareholders. Nor is the fact that the reorganization in the present case resulted from

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[1] See Levine & Petta, Libson Shops: A Study in Semantics, 36 Taxes 445, 449 (1958).

[2] See also *Fawick Corp.* v. *C. I. R.*, 342 F. 2d 823, 826 (6 Cir. 1965); *Federal Cement Tile Co.* v. *C. I. R.*, 338 F. 2d 691 (7 Cir. 1964); *Huyler's* v. *C. I. R.*, 327 F. 2d 767 (7 Cir. 1964); *Foremost Dairies, Inc.* v. *Tomlinson*, 238 F. Supp. 258 (M. D. Fla. 1963), aff'd, 341 F. 2d 580 (5 Cir. 1965).

the requirements which the bank imposed for business reasons a factor which should alter the conclusion. The Supreme Court pointed out in *Libson Shops* that its denial of the carryover was not based upon a finding that the shareholders had a tax avoidance purpose in bringing about the reorganization,[1] but resulted from the underlying purpose of the carryover provision itself. 353 U. S. at 388-90. A reorganization which seeks to extinguish the original plan by which there were established separate business units conducted by separate corporate entities cannot make possible the crossing of the lines of corporate identity by a loss carryover, for the carryover provision was designed only to aid the single business which had gone through a period of fluctuating income, and not to give an added advantage to the common owners of separate corporations.

Petitioner invokes Revenue Ruling 63-40,[2] which permits the carryover of a net operating loss where a corporation which is sustaining losses in its business acquires from unrelated sellers the assets of another business which it then carries on. This change in activity by the same corporation presents a situation which the Supreme Court in *Libson Shops* expressly noted was not reached by its opinion.[3] The Revenue Ruling is inapplicable where a group of shareholders choose originally the benefits of separate incorporation. It merely recognizes the general principle acknowledged by the Second Circuit in *Norden-Ketay Corp.* v. *C. I. R.*, 319 F. 2d 902, 906 (2 Cir. 1963): "It may well be that shareholders who sustain a loss and then are wise enough to liquidate an uneconomic enterprise

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[1] See § 129(a) of the 1939 Code, now § 269 of the 1954 Code.

[2] 1963-1 Cum. Bull. 46.

[3] See 353 U. S. at 390, n. 9; *C. I. R.* v. *Virginia Metal Products, Inc.*, 290 F. 2d 675, 677 (3 Cir. 1961), cert. denied, 368 U. S. 889 (1961); *Julius Garfinckel & Co., Inc.* v. *C. I. R., supra.*

and embark on a different and profitable field of endeavor through the same corporation are equally entitled to offset the earlier losses as those who see an unprofitable corporation through the lean years into the good ones in the same activity."

In its argument before us, petitioner has raised for the first time the contention that although the amount of the losses for the fiscal years ending March 31, 1953 and 1954 are to be calculated under the 1939 Code, the right to deduct them as loss carryovers in the fiscal years 1957, 1958 and 1959 is determined by the Internal Revenue Code of 1954.

Section 172(a) of the 1954 Code is a general provision authorizing the deduction of net operating losses which are carried over from former years; it is similar to the provision of § 23(s) of the 1939 Code. The 1954 Code, however, contains new provisions in § 381 and § 382 which deal with carryovers in certain corporate acquisitions and special limitations on net operating loss carryovers. Section 381, to the extent it is relevant here, provides that a corporation which acquires the assets of another corporation in certain tax-free transactions, such as a "D reorganization," shall succeed to the net operating loss carryover of the acquired corporation. §381(a)(2), (c)(1). Section 382 establishes two limitations on the carryover of a net operating loss: (1) it completely disallows any loss carryover where there has been a change of fifty percentage points or more in the ownership of the total fair market value of the outstanding stock of the corporation among any one or more of the ten persons who own the greatest percentage of the stock, and where the corporation has not continued to carry on substantially the same trade or business as that conducted before the change in ownership, (§ 382(a)); and (2) it imposes a proportionate reduction in the amount of the net operating

loss carryover permitted where in a reorganization such as a "D reorganization" the shareholders of the loss corporation immediately after the reorganization own less than twenty per cent of the fair market value of the outstanding stock of the acquiring corporation (§ 382(b)), a proportionate limitation which does not apply, however, if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportions. (§ 382(b)(3)).[1]

Petitioner argues that the maze of provisions in § 381 and § 382 which provide for the survival of a loss carryover in the hands of a transferee corporation and place limitations upon it, are inapplicable under their terms where it is the loss corporation which survives. From this it claims that it enjoys the right to the deduction of the net operating loss carryover under the simple authority of § 172(a), which, with §§ 381 and 382 inapplicable, is accordingly without limitation.[2] The result of their contention would be that a loss corporation absorbing by reorganization a profitable corporation would enjoy without any limitation the right under § 172(a) to deduct net operating loss carryovers. Although the language of § 382 does not indubitably lead to petitioner's construction of its meaning,[3] we are not required to decide the question. For by the express terms of the Code,[4] neither § 381 nor § 382 is applicable to the present case because they are

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[1] The provisions of §§ 381 and 382 are discussed at length in Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History under Libson Shops and Sections 269, 381 and 382, 69 Yale L. J. 1201, 1238-67 (1960).

[2] Section 269, which deals with attempts to avoid tax, concededly is not here involved.

[3] Thus, § 382(b)(1) applies "If . . . the transferor corporation or the acquiring corporation" has the net operating loss.

[4] Sections 393(b)(1) and § 394.

effective only where the plan of reorganization is adopted on or after June 22, 1954. Petitioner argues, however, that since under its view §§ 381 and 382 would by their terms be inapplicable where the loss corporation survives and thus § 172(a) would be operative without limitation, it is true a fortiori where §§ 381 and 382 are inapplicable because of their effective dates. In effect, this argument if accepted would mean that petitioner would obtain the benefit of whatever plan the 1954 Code envisages even though essential portions of the plan had not yet come into effect.

The law which existed on September 30, 1953 when the plan of reorganization was consummated was the 1939 Code. Its § 23(s) was substantially reincorporated in the 1954 Code as § 172(a). In these circumstances we see no reason why the taxpayer should be freed from the judicially created *Libson Shops* doctrine before the restrictions of § 381 and § 382 went into effect even if they should be considered to be congressional substitutes for the *Libson Shops* doctrine. If they were such substitutes, the fact that Congress held them in abeyance until June 22, 1954 in order to permit taxpayers to complete pending transactions in reliance on the former law,[1] can result in no less than the continued validity of the *Lisbon Shops* doctrine until they went into effect. In saying this we do not mean to indicate what our view would be in the case of a plan of reorganization adopted after June 22, 1954 which would bring into the problem the extent to which §§ 381 and 382 are substitutes for the *Libson Shops* doctrine and their applicability where an acquisition is made by a loss corporation by way of merger or other reorganization.

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[1] Senate Committee Report accompanying H.R. 8300, 1954-3 U. S. Code Cong. & Admin. News, p. 4925.

Finally, petitioner claims that in any event it should be permitted to deduct the full amount of the net operating loss of $211,012.93 for the fiscal year ending March 31, 1954, because it is less than the loss which the Cornelius mill sustained in the six months period after the reorganization. It recognizes that in the view we have taken of the case it can only set off losses of the Cornelius mill against profits of the Charlottesville mill in the six months post-reorganization period. The figures are not separated for the post-reorganization period and, as the Tax Court pointed out, some of petitioner's net loss of $211,012.93 may have been derived from losses incurred by the Cornelius mill in the pre-organization period. It is therefore impossible to determine on the record the post-reorganization net loss of petitioner, and since petitioner had the means to establish it but failed to do so, it cannot now complain.

The decision of the Tax Court will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 16,131

FRANK IX & SONS VIRGINIA CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

(T. C. Docket No. 3955-64)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:

THOMAS F. QUINN
Clerk

April 12, 1967

APPENDIX B

Here are set forth sections of the Internal Revenue Code of 1939, 26 U. S. C., and sections of the Internal Revenue Code of 1954, 26 U. S. C.

26 U. S. C., Internal Revenue Code of 1939.

Sec. 23. Deductions from Gross Income—

(s) NET OPERATING LOSS DEDUCTION.—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

Sec. 122. Net Operating Loss Deduction—

(b)—. . .
(2)—. . .

(B) Loss for Taxable Year Beginning After 1949.—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

(i) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) by determining the net operating loss deduction for each intervening taxable year, without regard to such net operating loss or to the net operating loss for any succeeding taxable year and without regard to any reduction specified in subsection (c).

For the purpose of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1949, shall be reduced by the amount, if any, of the net income for the preceding taxable year computed—

(i) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and

(ii) by determinnig the net operating loss deduction for such preceding taxable year without regard to such net operating loss and without regard to any reduction specified in subsection (c).

26 U. S. C., Internal Revenue Code of 1954.

Sec. 172. Net Operating Loss Deduction.

(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carryback to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(e) LAW APPLICABLE TO COMPUTATIONS.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

Sec. 269. Acquisitions Made to Evade or Avoid Income Tax.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation, or its stockholders the basis of which property, in the hands of the acquiring corpo-

ration, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, such deduction, credit or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

Sec. 381. Carryovers in Certain Corporate Acquisitions.

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b) (2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354 (b) (1) are met), or (F) of section 368 (a) (1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsection (b) and (c).

* * *

(c) ITEMS OF THE DISTRIBUTOR OR TRANSFEROR CORPORATION.—The items referred to in subsection (a) are:

(1) NET OPERATING LOSS CARRYOVERS.—The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:

(A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.

(B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(C) For the purpose of determining the amount of the net operating loss carryovers under section 172 (b) (2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section

172 (b) (2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—

(i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");

(ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;

(iv) the taxable income for such taxable year (computed with the modifications specified in section 172(b) (2) (A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;

(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172 (b) (2) (B), but without regard to a net operating loss year of the distributor or transferor corporation; and

(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172 (b) (2) (B).

Sec. 382. Special Limitations on Net Operating Loss Carryovers.

(a) PURCHASE OF A CORPORATION AND CHANGE IN ITS TRADE OR BUSINESS.—

(1) IN GENERAL.—If, at the end of a taxable year a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and

subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

(b) CHANGE OF OWNERSHIP AS THE RESULT OF A REORGANIZATION.—

(1) IN GENERAL.—If, in the case of a reorganization specified in paragraph (2) of section 381 (a), the transferor corporation or the acquiring corporation—

(A) has a net operating loss which is a net operating loss carryover to the first taxable year of the acquiring corporation ending after the date of transfer, and

(B) the stockholders (immediately before the reorganization) of such corporation (hereinafter in this subsection referred to as the "loss corporation"), as the result of owning stock of the loss corporation, own (immediately after the reorganization) less than 20 percent of the fair market value of the outstanding stock of the acquiring corporation,

the total net operating loss carryover from prior taxable years of the loss corporation to the first taxable year of the acquiring corporation ending after the date of transfer shall be reduced by the percentage determined under paragraph (2).

* * *

(3) EXCEPTION TO LIMITATION IN THIS SUBSECTION.—The limitation in this subsection shall not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion.

SEC. 393. Effective Dates of Parts III and IV.

(b) SPECIAL RULES FOR PLANS OF REORGANIZATION.—

(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), parts III and IV shall apply only in respect of

plans of reorganization adopted on or after June 22, 1954. For purposes of this paragraph and paragraphs (2) and (3), a plan to make a transfer to a controlled corporation described in section 351, or a plan to make an exchange or distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as a plan of reorganization.

Sec. 394. Effective Date of Part V.

(a) SECTION 381.—Except as otherwise provided in this subchapter, section 381 shall apply to liquidations and reorganizations, the tax treatment of which is determined under this Code.

(b) SECTION 382(a).—For purposes of applying the special limitation on net operating loss carryovers in section 382 (a), the beginning of the taxable years specified in clauses (i) and (ii) of section 382 (a) (1) (A) shall be considered to be the beginning of such taxable years or June 22, 1954, whichever occurs later.

(c) SECTION 382(b).—Section 382(b) shall apply to reorganizations, the tax treatment of which is determined under this Code.

Sec. 7851. Applicability of Revenue Laws.

(a) GENERAL RULES.—Except as otherwise provided in any section of this title—

(1) SUBTITLE A.—

(A) Chapters 1, 2, 4, and 6 of this title shall apply only with respect to taxable years beginning after December 31, 1953, and ending after the date of enactment of this title, and with respect to such taxable years, chapters 1 (except sections 143 and 144) and 2, and section 3801, of the Internal Revenue Code of 1939 are hereby repealed.

* * *

(C) Any provision of subtitle A of this title the applicability of which is stated in terms of a specific date (occurring after December 31, 1953), or in terms of taxable years ending after a specific date (occurring after December 31, 1953), shall apply to taxable years ending after such specific date. Each such provision shall, in the case of a taxable year subject to the Internal Revenue Code of 1939, be deemed to be included in the Internal Revenue Code of 1939, but shall be applicable only to taxable years ending after such specific date. The provisions of the Internal Revenue Code of 1939 superseded by provisions of subtitle A of this title the applicability of which is stated in terms of a specific date (occurring after December 31, 1953) shall be deemed to be included in subtitle A of this title, but shall be applicable only to the period prior to the taking effect of the corresponding provision of subtitle A.

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 334

FRANK IX & SONS VIRGINIA CORPORATION, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the circumstances under which losses, incurred prior to a corporate reorganization that preceded the effective date of the Internal Revenue Code of 1954, may be carried forward to offset post-reorganization profits earned in 1957, 1958, and 1959. Resolution of this question presents two issues: The first is whether, as petitioner contends, the carryover is governed by Section 382(b) of the 1954 Internal Revenue Code. If so, the Commissioner would agree the carryover is proper. On the other hand, if Section 382(b) is not the governing provision, the question becomes whether petitioner's carryover is allowable

275-593—67

under the continuity of business enterprise doctrine of *Lisbon Shops, Inc.* v. *Koehler,* 353 U.S. 382, which interpreted Section 122 of the 1939 Code.

The Tax Court held that the carryover was barred by *Libson Shops, Inc.* v. *Koehler, supra* (Pet. 19). The Third Circuit, affirming the decision of the Tax Court, held that *Libson Shops* applies with respect to corporations that are combined through a reorganization effected before the effective date of Section 382(b), as was petitioner, and that no loss carryover was available here (Pet. 27).

The decision below is correct on both issues. Such conflicts as exist with decisions of other courts of appeals are not of administrative importance sufficient to warrant further review by this Court.

Prior to September 30, 1953, petitioner manufactured woven synthetic fabrics in Cornelius, North Carolina. It incurred substantial net operating losses for the taxable years ending March 31, 1952, 1953, and 1954. On September 30, 1953, petitioner was reorganized pursuant to a plan whereby it acquired in exchange for shares of its own stock the assets of another corporation that manufactured the same type of fabric in a mill in Charlottesville, Virginia, and whose stock was owned by the same individuals in the same proportions as was petitioner's. The Virginia corporation was dissolved, and its holdings of petitioner's stock distributed to its stockholders. (R. 7a–11a.)[1]

[1] "R." references are to petitioner's appendix in the Third Circuit.

Petitioner continued to operate the Cornelius mill at a loss until July 22, 1954, when it was shut down. The Charlottesville plant continued to operate profitably, as it had prior to the acquisition (Pet. 18). On its federal income tax returns for the years 1957, 1958, and 1959, petitioner claimed deductions for the net operating losses sustained in the tax years ending March 31, 1953 and 1954.

1. Section 382 of the 1954 Code defines specific circumstances under which a corporation may not carry over losses incurred before a change in ownership or a reorganization against profits realized thereafter. By reason of Section 382(b)(3), however, such a carryover is available where, as here, there is a reorganization of two corporations owned "by the same persons in the same proportions." Accordingly, were this case governed by Section 382(b) the carryover would not be barred.

However, other sections of the 1954 Code make it clear that Section 382(b) could not apply to petitioner's claimed carryover. Section 394(c) provides that "Section 382(b) shall apply to reorganizations, the tax treatment of which is determined under this Code." Section 393(b)(1) provides that the 1954 Code "shall apply only in respect of plans of reorganization adopted on or after June 22, 1954. * * *" Since petitioner's reorganization took place in 1953, Section 393(b)(1) places the reorganization beyond the ambit

of the 1954 Code.[2] Consequently, Section 394(c) prohibits the application of section 382(b) in the present case, as the Third Circuit held. Accord, *Allied Central Stores, Inc.* v. *Commissioner,* 339 F. 2d 503, 504–505 (C.A. 2), certiorari denied, 381 U.S. 903.[3]

Petitioner is correct in asserting a conflict (Pet. 8) with respect to the effective date of Section 382 between the decision below and that in *Frederick Steel Co.* v. *Commissioner,* 375 F. 2d 351 (C.A. 6), petition for certiorari pending, No. 444, this Term.[4] The latter case involves Section 382(a) of the 1954 Code rather than Section 382(b). Section 382(a) sets forth rules that specify the circumstances in which a single corporation is barred from setting off against profits realized after a change in ownership (which is not the result of a tax-free reorganization) losses incurred before the change. The Sixth Circuit, apparently concluding that *Libson Shops* has no vitality if a deduction of a net operating loss is claimed in a 1954 Code year

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[2] Petitioner also fails to qualify for the election of the provisions of the 1954 Code, which Section 393(b)(3)(A)(i) makes available to reorganizations adopted after March 1, 1954.

[3] *Reo Motors, Inc.* v. *Commissioner,* 338 U.S. 442, is not, as petitioner asserts (Pet. 12), to the contrary. Petitioner seems to claim that *Reo* holds that the law governing the allowability of the operating loss deduction is the law in effect in the year when the deduction is claimed; but that is precisely the approach followed by the Third Circuit, which held that the effective-date provisions set forth in the 1954 Code make clear that the special rules of Section 382(b) are inapplicable here.

[4] The petition for certiorari in *Frederick Steel* asks this Court to review the case only if certiorari is granted in the present case.

regardless of when the loss occurred, ruled in *Frederick Steel* that Section 382(a) applied in the case of a single corporation whose ownership changed in 1952, and which sought to set off prior losses against profits earned in 1955 and later years, stating, "Section 382(a) is effective as to taxable years ending after June 22, 1954. See Section 7851(a)(1)(C) and Section 395(a) of the Code in 1954. We are here concerned with taxable years ending December 31, 1954, and subsequent years. Section 382 is, therefore, applicable to the taxable years here in question." 375 F. 2d at 354. Neither of the cited sections governs the applicability of Section 382 to pre-1954 losses; the Sixth Circuit plainly erred in holding that Section 382(a) and not *Libson Shops* applied to an attempt to carry over losses incurred before 1954 to profitable years thereafter.

The question as to the effective dates of Sections 382 (a) and (b) on which the Third and Sixth Circuits are in conflict relates only to the proper transitional rule; it arises only where a set off is sought of pre-1954 losses against post-1954 earnings of a corporation which was reorganized (Section 382(b)) or whose ownership changed hands (Section 382(a)) prior to June 22, 1954, the effective date of Section 382 of the 1954 Code. The Commissioner is aware of few pending cases,[5] in addition to the present one and *Frederick*

[5] In addition to the case of *Amherst Coal Co., et al.* v. *United States*, Nos. 2604–2606 (S.D. W. Va.), referred to in the government's petition for certiorari in the *Frederick Steel* case, further research has revealed these additional cases: *Supervised Investors Services, Inc.* v. *United States*, No. 66–C–45 (N.D.

Steel, in which this question is raised, and future cases are unlikely to arise. In these circumstances, this issue does not have sufficient administrative importance to warrant review by this Court.

2. The Third Circuit was also correct in holding that the carryover claimed by petitioner is barred by this Court's decision in *Libson Shops, Inc.* v. *Koehler, supra.* In that case a group of individuals owned the same proportionate interests in sixteen corporations which were engaged in the sale of women's apparel at retail, and in a seventeenth which provided management services for the others. The sixteen operating corporations were merged into the management corporation in a tax-free reorganization that did not alter the preexisting ownership ratios. The question was whether the 1939 Code allowed operating losses that three of the operating corporations sustained before the merger to be carried forward to offset post-merger profits of the consolidated enterprise. This Court held that the loss carryover was not allowable since the business that incurred the losses was not the same one that earned the profits. 353 U.S. at 390. Nothing was found in the legislative history of the loss carryover provisions to "permit the averaging of the premerger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger." *Id.* at 387.

Ill.); *Commercial Industries Co.* v. *United States,* No. 565–64 (D. N.J.); *Roberts Co.* v. *Commissioner,* T.C. Docket No. 6024–64. All four cases involve approximately $1,132,000 in total tax liability.

As the Third Circuit observed here, the facts in this case are "remarkably close to the circumstances which existed in *Libson Shops* * * *" (Pet. 21). Two corporate units, each a separate legal and economic entity when one of them incurred substantial losses, were reorganized into one entity, "and the assets which produced the income against which earlier losses were sought to be applied were different from the assets which produced the losses." (Pet. 21.) The result here is, moreover, in accord with the results reached in *Allied Central Stores, Inc.*, v. *Commissioner*, 339 F. 2d 503 (C.A. 2), certiorari denied, 381 U.S. 903; *Julius Garfinckel & Co.* v. *Commissioner*, 335 F. 2d 744 (C.A. 2), certiorari denied, 379 U.S. 962; *Huyler's* v. *Commissioner*, 327 F. 2d 767 (C.A. 7); and *Foremost Dairies, Inc.* v. *Tomlinson*, 341 F. 2d 580 (C.A. 5).

Petitioner is arguably correct in asserting a conflict between the results of applying the *Libson Shops* principle here and in *United States* v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808 (C.A. 5). In *Jackson Oldsmobile*, a corporation was allowed to carry over losses incurred during 1953 in selling Buicks in Colorado against profits earned during 1956 and 1957 in selling Oldsmobiles in Georgia. There was no reorganization, however, and throughout the period General Motors Corporation held a majority of the voting stock of the single corporation involved. The Fifth Circuit agreed with the district court that "under all the facts of this case, the principle of *Libson*

Shops, Inc. v. *Koehler* did not bar this carry over * * *."[6] It is not at all clear, however, that a conflict exists in the sense that on the present record the Fifth Circuit would have reached a different conclusion than did the Third. Compare *Foremost Dairies, Inc.* v. *Tomlinson, supra,* where the Fifth Circuit affirmed *per curiam* a district court denial of a loss carryover on the authority of *Libson Shops* in the presence of a corporate reorganization of a dairy and a frozen food processor into a single entity. See, also, *Norden-Ketay Corp.* v. *Commissioner,* 319 F. 2d 902, 905 (C.A. 2).

A decision by this Court in the present case could not in any event resolve any issue of substantial continuing importance. The Commissioner would concede that this case should have been decided differently if the reorganization had taken place on or after June 22, 1954. The Internal Revenue Service has ruled that it would not urge the rule of *Libson Shops* as an independent basis for disallowance of net operating loss carryovers as to any reorganization described in Section 381(a) of the 1954 Code, and thus governed by Section 382(b). See Rev. Rul. 59–395, 1959–2 Cum. Bull. 475, 480, and Rev. Rul. 58–603, 1958–2 Cum. Bull. 147. Accordingly, the question of the applicabil-

[6] In *Jackson Oldsmobile* the district court stressed that the case involved a single corporation whose majority ownership did not shift, rather than a merger of multiple corporations as in *Libson Shops*. This Court in *Libson Shops* distinguished and reserved judgment on cases where "a *single* corporate taxpayer changed the character of its business * * *." 353 U.S. at 390, n. 9 (emphasis in original).

ity of *Libson Shops* to cases such as this one, which would be governed by Section 382(b), will not arise in the future.[7]

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER 1967.

[7] The Service has also conceded that *Libson Shops* has only limited vitality in the single corporation cases governed by Section 382(a). See, Rev. Rul. 63-40, 1963-1 Cum. Bull. 46, and T.I.R. 773, October 13, 1965.

U.S. GOVERNMENT PRINTING OFFICE: 1967